A New Fiscal Blueprint for California's Future: A Call for Structural Reform

For over 50 years, California has built its economy on a foundation laid by the leadership of Governors like Earl Warren and Edmund G. "Pat" Brown and the legislative leaders of those eras. Roads and highways, water and sewer systems, and the world's most advanced higher education system were all part of an unparalleled commitment to California's future. It was a foundation for success that worked.

Over the years, however, this foundation has been obscured by an endless layering of new laws on top of old, with little thought of how State government would retain its ability to meet modern conditions and provide for the needs of citizens, coping with our changing economy and complex demographics.

Most recently, the State's ability to meet the needs of California citizens has been compromised by the severe volatility of State revenues. This volatility has significantly constrained the ability of the State to support necessary public investments to sustain economic growth in California.

Faced with the challenge of closing a $34.6 billion budget shortfall, some will choose to view the budget problem as a crisis of the moment. Closing the immediate budget gap is not enough, however. Policymakers must seize this opportunity to develop **a new fiscal blueprint for California**. We must view the budget problem as a moment of opportunity and design a new foundation for meeting the continuing physical infrastructure and human resources demands of California. The availability of educational opportunities, access to health care, the public health and safety of our communities, and the protection of our natural resources and environment all depend on undertaking this effort.

Toward this end, the Administration urges the following:

- Reforms to California's current fiscal structure must be an integral part of resolving the 2003-04 Budget.

- Reforms must consider changes to both revenue and expenditure policies.
- Administration and legislative leaders must begin work immediately and collaboratively to craft this new blueprint.

California's Current Fiscal Blueprint Is Obsolete and Irrational

For more than half a century, California's economy has fundamentally changed in response to global market forces. Defense spending fueled California's economy in the 1950s and 1960s. High-technology and other manufacturing industries emerged in the 1970s and 1980s. Although defense spending increased briefly in the 1980s, the downsizing of this industry, particularly aerospace manufacturing and services, led to the deep recession of the early 1990s. Other sectors in California's economy began to take hold during the 1980s. Foreign trade, high-technology manufacturing, professional services, and tourism and entertainment, helped to diversify and advance the state's economic base throughout the 1990s.

To support the changing California economy, public investments were made in the State's physical infrastructure and human resources. Many studies have noted the significant public investment commitment made in the 1950s and 1960s, including major expansions of the University of California, California State University, and the California Community Colleges; the construction of the State Water Project, roads, and highways; and a number of social welfare improvements.

The 1970s were marked by rapid inflation in consumer prices and wages, as well as increases in home values, with many property tax bills increasing as much as 40 percent over a few years. This large increase in property assessments led to a taxpayer initiative, Proposition 13, on the June 1978 statewide ballot. Overwhelmingly approved by California voters, Proposition 13 cut local property taxes statewide by over 50 percent and limited the rate of property tax growth, resulting in a dramatic drop in revenue to counties, cities, special districts, and schools. To avoid financial disaster for local governments, lawmakers cut State spending and "bailed out" local governments with the State's then multi-billion dollar surplus.

Proposition 13 dramatically altered the landscape of State and local finance. It halted the unprecedented level of spending for roads, highways, and colleges and universities cutting short this investment in the State's infrastructure. More importantly, Proposition 13 encouraged a 25-year epoch of ballot-box propositions that have continued to complicate State and local financing, including the following examples:

- Proposition 4, approved by voters in November 1979, limited annual increases in State and local spending to inflation and population growth.
- Propositions 6 and 7, approved by voters in June 1982, abolished the State gift and inheritance taxes and indexed State income taxes to inflation, respectively.
- Proposition 37, approved by voters in November 1984, established the State Lottery and dedicated revenues to education.
- Proposition 62, approved by voters in November 1986, requires two-thirds approval by a local governing body and major voter approval for new local general taxes.
- Proposition 98, approved by voters in November 1988, established a minimum State funding level of K-12 schools and community colleges.
- Proposition 99, approved by voters in November 1988, imposed a surtax on cigarettes (25 cent) and other tobacco products to generate revenues for primarily health-related purposes.
- Proposition 163, approved by voters in November 1992, repealed the "snack tax" and limited the taxation on certain food items.
- Proposition 172, approved by voters in November 1992, imposed a one-half cent sales tax increase to generate revenues for local public safety purposes.
- Proposition 218, approved by voters in November 1996, limited the authority of local governments to impose taxes, assessments, fees, and charges and clarified that local general taxes and special taxes require majority and two-thirds voter approval, respectively.
- Proposition 10, approved by voters in November 1998, imposed an additional surtax on cigarettes (50 cent) and other tobacco products to generate revenues for early childhood development programs.
- Proposition 39, approved by voters in November 2000, allows for the enactment of local general obligation bonds for school facilities with 55 percent voter approval.
- Proposition 42, approved by voters in March 2002, permanently dedicates revenues from the sales tax on gasoline, previously deposited into the General Fund, to transportation purposes.
- Proposition 49, approved by voters in November 2002, requires State funding for after-school programs pursuant to certain conditions being met.

Most of these measures enacted over the last 25 years have limited the amount of funds available to the State or local governments. Other voter-approved changes have mandated increased State and local spending for some programs. Still other restrictions have been placed on the manner in which local governments can raise revenue, commonly by increasing the percentage of voters who must approve these revenue increases—complicating local governments' ability to respond to local conditions and citizen demand for services. Yet other voter-approved measures have simply transferred moneys from one kind of spending to another.

These numerous changes not only limited State and local fiscal discretion, but were adopted in a piecemeal fashion rather than as overall solutions to spending concerns. The practical result is a State and local fiscal system that is irrational. California's current fiscal structure, the underpinning of our public investments in physical infrastructure and our human resources, has not been updated for a very long time. Since 1978, California's population has grown from around 23 million to over 35 million persons, and the demographics of our state have changed significantly.

Finally, the volatility of California's revenues has severely constrained the ability of the State to support necessary public investments to sustain economic growth in California. California's current fiscal crisis is primarily attributable to the precipitous drop in the stock market, which led to an equally sharp drop in capital gains and stock option income. Two years ago, these revenue sources comprised 25 percent of total General Fund revenues.

The Governor's Budget forecasts capital gains and stock options at 11 percent of total General Fund revenues in 2001-02 and 8 percent in 2002-03 and 2003-04. Thus, the largest proportion of our current budget problem results from the fluctuating income from capital gains and stock options.

The relationship of these income sources to stock market performance and to the timing of the economic recovery in California and the nation makes State personal income tax revenues inherently volatile.

A Call to Action

California can no longer support critical public services with an obsolete fiscal blueprint. It is time to make changes in the way we do business and government in this state. Numerous reports by public and private organizations clearly show that the State's fiscal system is incapable of maintaining our public spending commitments.

This Budget must not only be a balanced spending plan for the 2003-04 fiscal year—it simultaneously must resolve our fiscal structural problems by adopting reforms to our outdated revenue structure and reforms to our fiscal and budget tools to protect the State's ability to continue support for vital services in the event of future economic downturns.

California must have a new blueprint for the future.

Numerous commissions and studies, including the California Constitution Revision Commission and the California Citizens Budget Commission, have focused on State and local fiscal reforms. Their recommendations have largely been ignored. Special interest objections to any change have often led to governmental deadlock, even though the need for reform is clear. Enough studies have been done. Structural reform is fundamental to resolving the State's budget crisis. Now is the time for policymakers to make the tough choices that will enable California to invest in our human resources and physical infrastructure, critical public commitments for sustained economic growth.

Reforms to California's current fiscal structure must be an integral part of resolving the 2003-04 Budget. In order to begin this dialogue, the Administration places the following reform proposals on the table for consideration during 2003. The Governor will convene the bi-partisan legislative leadership in February to discuss these proposals and solicit other reform proposals for consideration. In addition, the Administration will consult with representatives of major stakeholder interests.

If enactment of the 2003-04 Budget fails to include reforms to our fiscal structure, it will be a failure. Fundamental structural reform is integral to this Budget.

Structural Reform Proposals for Consideration

- **Allow mid-year budget adjustments and suspension of statutes—**Restore the Executive Branch authority, which existed prior to 1983, to make mid-year budget adjustments when revenues fall significantly below anticipated levels. This would also allow the Governor to make statutory changes affecting programs, including entitlement programs.
- **Create a State budget reserve to mitigate the volatility of the State's revenues, and re-evaluate current spending limit requirements—**Require that once the Special Fund for Economic Uncertainties has been established at the appropriate level, any proceeds from extraordinary revenue growth, particularly from volatile revenue sources, be placed in a reserve fund for one-time purposes.

- **Require sunset review of all "automatic" spending laws—**Require periodic review of all constitutional or statutory spending laws. This would provide an opportunity for the Legislature and the public to discuss the wisdom of continuing guaranteed funding increases.
- **Require sunset review of all tax breaks—**Require periodic review of all tax breaks. As with automatic spending laws, the existence of hundreds of tax breaks for businesses and individuals reduces moneys available for desired spending. These tax breaks often continue long after the rationale for their adoption has disappeared. Under this proposal, every tax expenditure currently authorized would sunset and be extended for a period of five years only after the effectiveness of the tax expenditure has been determined.
- **Request that the Legislature revise its appropriations process to require the identification of future year costs of legislation, and to identify the funds available to pay those costs—**Request that the Legislature evaluate the cost of proposed legislation beyond the initial year of implementation to more fully understand the future funding implications. Currently, the fiscal impact identified for most legislation is often limited to those costs in the year of adoption and perhaps a few years later. The projected costs in future years are often not available to legislators who must vote on these bills. At the same time, it is essential that legislation identify the source of funding for future year costs.
- **Rebalance the portfolio of State revenue to achieve a more stable mix of major revenue sources—**Dependence on more volatile revenue sources has hampered the State's ability to consistently meet funding demands in critical programs. The State needs to examine ways to more fairly allocate the tax burden and reduce revenue volatility.
- **Rebalance the portfolio of local government revenue to achieve a better mix of major revenue sources, and encourage "rational growth" decisions—** Acknowledge the fact that the current revenue structure virtually forces local governments to make unwise land use decisions. Known as the fiscalization of land use, this leads to intense competition between neighboring cities over the location of businesses. Local competition for retail stores or auto malls to generate sales tax revenue rarely balances community housing needs or the benefits of non-retail business and industry. The competition also exacerbates transportation and environmental problems. Property tax revisions, such as changing the manner in which commercial properties are re-assessed, might provide improved fiscal incentives for local governments to address local needs.

- **Restore local community control of programs and revenue raising—**Provide reasonable revenue-raising tools to local governments. In addition, realignment of State and local programs and revenue is essential. This Budget includes an $8.3 billion State-Local Program Realignment proposal, assigning program responsibilities to the appropriate level of government and allowing local governments to exercise greater discretion in program administration and service delivery (see Preserving Critical Programs section). Equally essential is a complete review of statutory mandates on local governments. After a complete review of statutory mandates on local governments, those mandates determined to be unnecessary should be repealed.